By email only: pensions.investment@dwp.gov.uk

Aysha Ahmed and Andrew Blair
Department for Work and Pensions

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Dear Aysha and Andrew

SPP Response to consultation on Future of the defined contribution pension market: the case for greater consolidation

We welcome the opportunity to respond to this consultation.

Executive Summary

The trust law of yesteryear, which led to employers running their own schemes, may seem like an anachronism from the perspective of today's 'big provider', multi-employer perspective. It is indeed true to say that not all schemes are well run, and that not all offer good value. However, it is also true to say that there are some outstanding examples of well-run single employer trust DC schemes which offer great value, and which are backed by employers who believe that pension provision for their workforce goes beyond contribution input, despite members rarely appreciating the additional efforts and costs they expend to achieve good outcomes.

Moreover, it should not be overlooked or underestimated that the way most single employer trusts (which we refer to as the unbundled model) are structured gives rise to a value benefit to members which exists only by exception in a true bundled model. This is of course because the employer is paying the fees for, inter-alia, administration, trustee costs, legal advice, investment advice and other consultancy advice including support for the growing numbers of statutory disclosure obligations. In a true bundled scheme, members will pay for all of these activities. It is not unreasonable to assume that the costs of these services has a beneficial impact on the reduction in yield (net investment returns) of anywhere between 15 and 30 basis points. Scale and governance standards alone cannot necessarily bridge this gap. When taking into account the potential for transition costs involved in asset transfers, to which we refer in more detail in our response, it could take several years for a 'better value' consolidator scheme to bridge the gap created by this loss and still more to overtake it meaningfully. Indeed, many members, the older demographics and those who transfer out in particular, may never derive better value from consolidation. These are factors which are referenced in the call for evidence and which Government clearly understands. Therefore, with the benefit of consolidation to members neither clear nor certain (see answer to Q1), there is a real question over whether better member outcomes is genuinely at the heart of this consolidation policy or whether, in fact, there are other drivers. Encouraging greater collaboration in infrastructure investment is clearly one of these

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drivers; simplifying the regulatory burden for TPR is possibly another. We do not believe that either or indeed both of these objectives is without merit in their own right (although we would expect to see a beneficial impact on the general levy if the latter is achieved) but we feel that greater transparency is merited. If consolidation is portrayed as a policy to deliver value to members and is quickly and easily demonstrated not to do so, fragile confidence in the pension system could be undermined. We do not believe that Value for Money is a purely mathematical metric (net investment returns) nor do we believe that the imposition of arbitrary reporting periods is safe or desirable. Different investment strategies are designed for different return and risk objectives and will experience different outcomes in different economic cycles. This is not synonymous with value. Moreover, ESG considerations are notably absent from this metric. We are not yet at a stage where it is possible to unequivocally evidence that sustainable investment is achieving a better return than investment strategies that seek return above and beyond any other consideration. Consequently, a single value metric which is focussed solely on net returns could lead to situations which are contradictory to current Government policy on sustainable investment.

In our detailed response we reference what we perceive could be a market risk – a comparatively low number of suitable consolidators which create an oligopoly. We believe that this could be of concern to the CMA.

Yours sincerely

Tim Box
Chair, DC Committee, SPP

Fred Emden
Chief Executive, SPP

<u>Detailed Response</u>

Question 1
Do you agree that the government is right to aim for fewer, larger schemes going forward? Are there any risks?

Government's overriding aim should be to improve member outcomes. Consolidation may achieve this outcome but size is not synonymous with quality and value. It may be that fewer, larger schemes will lead to that but what "larger" means is key. The proposed £5bn upper threshold seems too high. Larger schemes have sufficient financial weight – and generally speaking will have experienced Trustees Boards and governance structures which, supported by advisers, can often negotiate advantageous terms. Indeed, the fact that they are not vertically integrated with an administrator and/or asset manager (as are many Master Trusts) can lead to even greater levels of value delivered through the ability to go to market to tender for services. Therefore, the larger a single employer trust is, the less likely it is that consolidation will improve member outcomes.

The value of the employer's operating financial contribution must not be overlooked or underestimated. Most single employer trusts (which we refer to as the unbundled model) are structured in such a way that there is an inherent value to members which exists only by

exception in a true bundled model. This is because the employer is paying the fees for, inter-alia, administration, trustee costs, legal advice, investment advice and other consultancy advice including support for the growing numbers of statutory disclosure obligations. In a true bundled scheme, members will pay for all of these functions and activities. It is not unreasonable to assume that the costs of these services has a beneficial impact on the reduction in yield (net investment returns) of anywhere between 15 and 30 basis points on a recurring basis. Scale and governance standards alone cannot necessarily bridge this gap. This (and the fact that it would be neither practicable nor meaningful[1] to 'redirect' these employer savings as a higher pension contribution) means that employers, rather than members, are likely to be the primary beneficiary.

If a net of fees return is the only (or most significant) metric, the value to members of the unbundled model is such that a side by side comparison of net returns will often favour that unbundled model, and so defeat the policy objective. This is especially so when considered with transition costs, which we address later in this response. We suggest that to avoid this outcome, it would be necessary to expand the number of value metrics. These could include requirements to:

i. Evaluate the strength of the employer's 'DC covenant' to enable trustees to determine whether they can reasonably rely on the continued support of the employer to meet all non-investment operational fees within the 'unbundled' model. Where the scheme is administered in-house, this covenant assessment could include some assurance about the employer's willingness and ability to fund future technology improvements, as well as its people commitment.

ii. Evaluate and compare whether the scheme offers access to Freedom and Choice options without significant barriers such as minimum pot size, material transaction fees or higher ongoing charges.

iii. Evaluate and compare the engagement methodologies including digital solutions and if possible the success rate of specific, targeted messages such as nudges to self-select a different investment pathway than the default.

iv. Evaluate and compare core and scheme specific data quality.

Risks include:

- **Transition costs**: the costs (to members) of selling and buying assets will be one of the key fiduciary concerns of the trustees. It is not unreasonable to assume a rule of thumb 1% round trip for transition – whereby the value of the assets on T+1 is 1% below the value on T (transfer date). Transition management can alleviate these costs but there is a capacity limit within the market for effective transition management and some costs simply cannot be mitigated. The reality for smaller schemes is that transition management is often less successful. Where a particular fund within a portfolio is below £5m, it is not untypical for no transition management to be attempted. Government can play a

[1] This assertion is based on administration fees lying typically in the range of £10 to £25 per member per annum. Advice, audit and compliance cost savings would increase the amount of employer spend available for 'redistribution' but not significantly, and as a substantively fixed cost will vary pro rata according to membership size. Even if was possible for the employer to boost contributions, deferred members would be disadvantaged, which would then call fairness into question for the ceding trustees.

significant role in relieving this issue (see answer to questions 3 and 4). Without this support, we could induce a situation whereby Government is seen to be taking money from members' pension pots to support a different policy objective, whilst portraying it as a better member outcome. Indeed, we feel that Government must play a significant role in order to avoid the type of headlines that could significantly undermine trust in the system.

- **Loss of employer engagement:** Some employers may lose interest in ensuring their employees benefit from well-governed and competitive pension benefits if their only statutory requirement after consolidation is to pay minimum contributions into a master trust, for example. Representatives of the SPP cite examples of something similar happening when employers have set up GPPs and then not reviewed them for many years.

- **Market capacity to consolidate**: This bottleneck risk would be heightened by our expectation that only a relatively small number of Master Trusts will have the lion's share of the consolidation market. This could retard the speed with which consolidation can be achieved.

- **Creating an oligopoly:** This could lead to reduced competition and less customisation possible for specific membership groups. This is particularly important where schemes have specific demographics where customisation can be better achieved. This would include alignment of members' ESG preferences with the trustees' investment strategy – which is more difficult (although not impossible) to achieve in a large MT than in a single employer trust focussed on that demographic.

  The oligopoly risk is heightened by the expectation that consolidation will be focussed on a relatively small sub-set of commercial Master Trusts. GPPs are unsuitable consolidation vehicles due to the need for members to agree to transfer accrued benefits to the selected provider (or another of their choice). Where they do not, the trustees will need to transfer the residual members' pots either to a Master Trust or s32 policy (the latter of which are not widespread in the UK market and are often legacy products where product investment is on a 'maintenance only' basis; notably they are not subject to independent oversight such as an IGC). The charges that the trustees can negotiate with the receiving Master Trust or s32 provider will be related to the remaining asset size and member demographic but the likelihood is that the trustees' ability to negotiate competitive charges will be diminished.

- **Conflicts of interest:** These exist in a number of areas but especially within Independent Professional Trustee Companies and Consultants whose future career opportunities would be limited by widespread consolidation, but who would be instrumental in delivering the policy outcome; we believe that employers' input (their preference for future pension provision) will be instrumental in overcoming any conflicts and should be a key consideration of the trustees.

- **TUPE:** Will consolidators face this risk, especially where there is in-house admin?

- **Consolidator longevity:** Go-to-market GPPs can and do become legacy products which are often sold on. Master Trust Funders' strength to weather storms and endure losses is unproven and the weaker will fall. Longevity and financial strength must be core components of the value benchmarking. This implies that trustees could need to evaluate

commercially sensitive data (such as reserves and progress against Business Plan) of consolidator Master Trusts. This could negatively impact the strength of support for Master Trusts which are considered higher risk which in turn could undermine their success.

- **Tax free cash sums:** Where members have both DB and DC benefits within a hybrid scheme, and where tax free cash 'commutation' would ordinarily be from the DC pot, members may suffer through poor value DB commutation rates. Some form of DC pot repatriation process (whereby members could transfer back to the (now pure) DB scheme would resolve this. Part of the consolidator schemes VFM assessment could therefore include their ability to 'repatriate' members' DC pots with their DB benefits pre-retirement via nudges and targeted communications. This would, however, require a long-standing commitment from the employer and trustees to accept transfers back for this purpose and would be made more complex by buy-outs which, without a legislative easement, would inhibit the ability for providers to repatriate these DC pots and therefore prevent members from using their DC assets from that employment for cash purposes before DB commutation.

- **Loss of A day tax protections**: For example, where partial transfers arise in hybrid schemes.

Question 2
What impact will the new value for members assessment have on consolidation of schemes under £100m? If you were a scheme that did not pass the value for members assessment, would you look to "wind up" or "look to improve" and how would you go about this? Beyond the value for money assessment, could government, regulators and industry accelerate the pace of consolidation for schemes under £100m?

The new VFM assessments for schemes under £100m have not yet started and in our view it would be better to ask this question at some point in the future when there will be practical experience of the effect of the assessments. But in our opinion since the threshold test of £100m covers total scheme assets, virtually all hybrid schemes will be excluded due to the value of their DB assets. Similarly, pure DC schemes which have not been operational for three years are exempt, although it seems unlikely that many will exist. The actual number of members affected therefore seems likely to be a relatively small proportion.

Our expectation is that most trustees of schemes that do not pass the VFM assessment will initially look to improve before winding up. Government has acknowledged that costs of consolidation can be material and we have referenced in our response to Q1 the very real potential for conflicts. By contrast, we believe that many employers will prefer consolidation, given the benefits to them of a reduction in benefit spend and regulatory risk and burden.

We believe that in due course industry will develop tools, processes and risk mitigation strategies that will streamline both analysis and consolidation project management, and these tools will be re-usable irrespective of scheme size. Even so, we believe there will be a capacity risk and it would perhaps be more logical to tackle the policy objective from the perspective of poorest value/weakest DC covenant rather than size. Doing so in this manner would likely create a situation whereby more members but fewer schemes would be 'consolidated' whereas the

current proposals mean that more schemes but fewer members would be consolidated.

Question 3
How can government incentivise schemes with assets of between £100m-£5bn to consolidate?

We do not believe that it would be practicable, politically palatable or affordable for Government to meet the advisory and project management costs of consolidation which, for many schemes, will surpass a material six figure sum Therefore the best ways to incentivise schemes would seem to be:

- Relieve the ceding trustees of the stamp duty liability associated with selling and buying assets in a different trust. This is a vitally important consideration which stands as a serious impediment to consolidation success, as we have noted above.
- Simplify the regulatory and financial burden by, for example, confirming that a full market review of potential providers is not necessary provided the trustees have fully assessed and documented the capabilities and fee structure of a comparator authorised Master Trust which is willing and able to accept the members and assets within an acceptable (to be defined) timeframe.
- Waive certain disclosure obligations of the transferring trustees (such as Chair's Statement and TCFD Disclosure) during the wind-up period.
- Allow flexibility for the wind-up period to mitigate the capacity crunch risk. Trustees' decisions should be based on the quality of the selected consolidator provider, not driven by implementation timelines. That is, that it could be preferable to consolidate into a higher value consolidator scheme in 2 years' time, when they have an appropriate window to do so, than consolidate into an inferior consolidator scheme in 1 year.

Question 4
Assuming a scheme wishes to consolidate, how significant are the barriers identified above? Are there others? How do barriers vary for medium-larger schemes?

The barriers identified above are fundamentally the same irrespective of size.

The most significant barrier is Transition Cost which we cover elsewhere.

How can the government, regulators and industry remove these barriers?

How can government incentivise consolidation for schemes between £100m and £5bn especially where there may be a proportion of members who have smaller pots and therefore may be less attractive to receiving schemes? Could government incentivise trustees of both the merging and receiving schemes to take a mixed economy of smaller and larger pots or could this be provided by the market at a suitable cost, and without imposing additional cost consequences on members?

We have made a number of suggestions in our response to Q3. We believe that the stamp duty issue flagged in the first bullet is of vital importance, adding a cost of up to 0.5% of asset values which will require several years or more to recoup in many situations.

Question 5
How can we mitigate any risks associated with scheme consolidation?

Our bullet point responses to Q3 suggests some mitigating factors.

In Q1 we highlighted a risk about the loss of employer engagement after consolidation. To mitigate against that employer should be required to diligently review their pension arrangements on a regular basis (say every 3 or 5 years).

Another risk we perceive is consolidating into a scheme which, over time, offers less value or which is itself wound up. This could be mitigated by mandating strict criteria for trustees to consider when selecting comparator schemes including (but not limited to) Funder strength, progress against Business Plan and scheme scale.

Question 6
What other international good practice exists?

We believe that the situation in the UK is different to other countries. In part this is attributable to the low cost environment in which all workplace DC schemes operate, whether bundled or unbundled, which means that value metrics are less pronounced and apparent. In part this is also attributable to legacy pension legislation, and to legacy pension products, which have built up over time to induce highly complex wind-up scenarios.

Question 7
How important is scheme consolidation in driving better member outcomes?

What more can government and industry do to move away from a narrow focus on low costs and charges to a broader assessment of value for money that encompasses investment strategies whether innovative or otherwise and overall net returns?

As we noted in Q1 we are not convinced there is an automatic correlation between scheme consolidation and driving better member outcomes. We believe that the strength, commitment and sustainability of a scheme is a pre-requisite of driving better member outcomes, whether that is a single employer trust or a commercial master trust.

Engagement methodologies are vital in improving member outcomes. The best seek to encourage members to make good decisions or, at worst, to avoid poor decisions.

With Regards to the specific questions asked:

- **creating a new value for members assessment specifically for single-employer schemes**

We question why this should be restricted to single-employer trusts and why a "£1bn Master trust" is perceived as offering better value than a "£1bn Single Employer Trust" noting that the latter which is not set up to make profit is likely to offer better value and a lower risk to member outcomes than a commercial scheme whose Funder doesn't achieve their financial ambition.

- **setting a floor on net returns below which schemes must explore winding-up the scheme**

We believe this is a crude measurement in isolation, as noted elsewhere. Arbitrary time weighted metrics and different contribution inflows and outflows will distort the outcome – a money weighted approach is equally important – and possibly more so - in identifying investment value as a time-weighted approach. Consideration is also needed as to how black swan events would be

treated, such as the market crashes of 2009 and March 2020.

- **greater powers for the Regulator to act where they have evidence of poor governance/performance**

This will depend on what evidence is collected and what reliability can be given to it. It seems unlikely that a desk-based assessment on its own will be wholly reliable and we think the Regulator would need more resources to effectively implement any further powers it is given.

- **financially incentivising employer sponsors of single employer trusts to close the scheme**

We have commented that we do not believe it would be practicable – or even politically palatable – to incentivise employers to – essentially – reduce their benefits spend. We have instead posited some alternative levers for consideration.

Question 8
How can government, regulators and industry incentivise scheme consolidation?

As noted above in our response to Q3, we believe there are several legislative levers available which would streamline process and risk without requiring direct financial support. The most important of these relates to stamp duty in transition management. Simplifying the legislative requirements for 'in flight' transitioning schemes, and not requiring employers to recycle their benefit savings are also critical.

Question 9
Is there anything else, not covered in the other questions, that the government should consider?

We believe that the well-aired problem of small pots is one of, if not the, greatest threats to DC pensions in the UK.

Small pots are a consequence of the wider economic backdrop and employee behaviour. Their presence is an inevitable drag on:

- Employer costs in an unbundled scheme.
- Member costs in a bundled scheme, since the losses generated by those small pots must be recovered from larger pots. Without a 'small pot Reduction in Yield drag' many members with larger pots would benefit from lower charges and, all things being equal, better outcomes.

We are of course aware of other work that is ongoing which seeks to resolve this issue, but we expect that any whole of market solution is still several years away from being implemented.

We believe there is merit in reconsidering small pot refunds. In the past this was on a time weighted basis (due to preservation requirements) which was illogical for DC benefits. A money weighted threshold for small pot refunds could improve value across the spectrum even if the refund was to include the value of the employer contribution (which previously was 'lost' to members and 'reclaimed' by employers).

For hybrid schemes where members have both DB and DC benefits, we would urge Government to consider the effect of partial transfers on the preservation of A day protections.

Response ends

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